

Cronin Communications Consultants

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OFFICE OF THE
EXECUTIVE SECRETARY

David Waddell, Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

May 3, 2002

RE: MountaiNet Telephone Company, Inc. (Docket No. 02-00446)

Dear Mr. Waddell:

This letter is in response to the April 25, 2002 request for information regarding the application by MountaiNet Telephone Company ("MountaiNet" or "Applicant") for a CCN pursuant to TCA §65-4-201. Per that letter, I provide the following information:

Financial Requirements

1. Current 12/31/01 audited financial statements including balance sheet, income statement and statement of cash flows are included as Attachment 1 of this document. Because Applicant is a new enterprise without its own audited financial statements, information is provided for the consolidated Scott County Telephone operations.
2. The Applicant was asked to explain the lack of correlation between three schedules provided in the original filing. Additionally, a three-year forecast of depreciation expense was requested. Upon review, it was found that the original schedules submitted to the TRA used inconsistent naming conventions between them and the inconsistency extended to the use of sub-totals on the individual worksheets. These errors made correlation of the capital expenses between the various exhibits an impractical exercise.

Attachment 2 provides revised exhibits that clarify the company's anticipated capital and network expenditures. There has been no change in the actual investment amounts shown in the original worksheets. There remains, however, a single slight discrepancy between the various capital expenditures because the company has included, without detailed analysis, a small amount of capital (\$5000) investment in furniture and office equipment associated with minor investment in operating support equipment.

The statement of forecasted financials has been revised, however, to include minor additional revenue with access services inadvertently omitted from the original filing.

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Lastly, the requested depreciation schedule for all capital expenditures excluding furniture and office equipment is also included in this attachment.

As in the original filing, the information provided in this Attachment is competitively sensitive and this attachment is provided in a separate sealed envelope and the Applicant respectfully requests confidential treatment thereof.

3. As stated in the original filing, the Applicant will receive funding from four distinct sources: 1) local commercial lenders in Tennessee and Virginia who have provided such funding in the past; 2) stock purchase by its parent company, Scott County Telephone Cooperative; 3) profits from existing deregulated operations including internet and long distance; and 4) a major contract with a large provider in Virginia that includes immediate capital contributions to the Applicant's capital requirement.

4. A photocopy of MountaiNet's corporate surety bond was provided with the original application. The original of that bond is provided in Attachment 3 of this letter.

Miscellaneous Items

1. TRA requests information regarding cost allocation between MountaiNet and its parent company, Scott County Telephone. In addition to the Applicant, Scott County Telephone owns several deregulated operations with which it maintains an "arms-length" relationship. Accordingly, as a borrower Scott County was required to file with the U.S. Department of Agriculture Rural Utilities Service ("RUS") its Management Services Agreement. That Agreement, included in Attachment 4 of this letter was approved by RUS on March 13, 1996.

2. As stated above, RUS has approved Scott County's Management Services Agreement. Additionally, the company's independent outside auditors follow RUS guidelines in audits of the consolidated operations. Actual cost allocation is administered by Scott County's Chief Financial Officer.

3. The Applicant intends to provide the TRA full access to its books and records as required by the TRA. Additionally, audited financial results for Scott County Telephone are submitted to members to the business community at large (Dunn and Bradstreet, etc.) and would be made available to TRA upon request.

If there are any additional questions, please call me at 770-649-1886.

Sincerely,



Eileen M Bodamer

Consultant to MountaiNet Telephone Company, Inc.

Enclosure (original plus 13 copies)

Cc: Blane Clark, MountaiNet Telephone Company

MountaiNet Telephone Company
May 3, 2002

Attachment 1
Audited Financial Statements Ending 12/31/01

**SCOTT COUNTY TELEPHONE COOPERATIVE
AND SUBSIDIARIES**

Gate City, Virginia

**INDEPENDENT AUDITORS' REPORTS
CONSOLIDATED FINANCIAL STATEMENTS
AND
CONSOLIDATING INFORMATION**

As of and for the Years Ended
December 31, 2001 and 2000

**SCOTT COUNTY TELEPHONE COOPERATIVE
AND SUBSIDIARIES**

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Turlington and Company, L.L.P.

Certified Public Accountants

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Scott County Telephone Cooperative and Subsidiaries
Gate City, Virginia

We have audited the accompanying consolidated balance sheets of Scott County Telephone Cooperative and Subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of revenues and expenses, capitalization, and cash flows for the years then ended. These consolidated financial statements are the responsibility of Scott County Telephone Cooperative and Subsidiaries' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Scott County Telephone Cooperative and Subsidiaries as of December 31, 2001 and 2000, and the results of their operations, and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 1, 2002, on our consideration of Scott County Telephone Cooperative and Subsidiaries' internal control over financial reporting and our tests of their compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Turlington and Company, L.L.P.

March 1, 2002

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

	December 31	
	2001	2000
ASSETS		
Current assets:		
Cash and temporary investments	\$ 1,271,643	\$ 1,399,224
Customer accounts and notes receivable (less, allowances of \$139,968 and \$121,405, respectively)	591,832	622,196
Other accounts receivable (less, allowances of \$10,000 each year)	329,806	345,027
Materials and supplies	398,989	375,190
Prepayments	50,795	38,637
Deferred charges	69,844	42,192
Deferred income taxes	26,164	29,836
	<u>2,739,073</u>	<u>2,852,302</u>
Noncurrent assets:		
Investment in equity securities	268,510	358,749
Other investments	2,719,908	2,631,781
Intangible assets (less, accumulated amortization of \$217,318 and \$191,236, respectively)	484,660	550,158
Deferred income taxes	189,753	130,381
	<u>3,662,831</u>	<u>3,671,069</u>
Property and equipment:		
Plant in service	24,863,817	24,004,873
Plant under construction	1,336,377	1,075,215
	<u>26,200,194</u>	<u>25,080,088</u>
Less, accumulated depreciation	<u>13,567,578</u>	<u>12,181,613</u>
	<u>12,632,616</u>	<u>12,898,475</u>
	<u>\$ 19,034,520</u>	<u>\$ 19,421,846</u>
LIABILITIES AND CAPITALIZATION		
Current liabilities:		
Accounts payable	\$ 584,549	\$ 801,297
Customer deposits	43,876	31,856
Current maturities on long-term debt	908,519	1,551,592
Accrued and other current liabilities	544,200	430,541
	<u>2,081,144</u>	<u>2,815,286</u>
Noncurrent liabilities:		
Long-term debt, less current maturities	7,354,085	7,905,178
Deferred compensation	101,295	111,789
Postretirement benefits	1,264,367	1,040,141
	<u>8,719,747</u>	<u>9,057,108</u>
	<u>10,800,891</u>	<u>11,872,394</u>
Capitalization:		
Memberships	118,289	116,903
Accumulated other comprehensive income	7,327	8,253
Patronage capital	8,108,013	7,424,296
	<u>8,233,629</u>	<u>7,549,452</u>
	<u>\$ 19,034,520</u>	<u>\$ 19,421,846</u>

The accompanying notes are an integral part of the consolidated financial statements

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CAPITALIZATION Years Ended December 31, 2001 and 2000

	<u>Total</u>	<u>Comprehensive Income</u>	<u>Memberships</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Patronage Capital</u>
Balances, December 31, 1999	\$ 6,427,200		\$ 116,673	(\$ 3,331)	\$ 6,313,858
Comprehensive income:					
Net margins for the year	1,093,246	\$ 1,093,246			1,093,246
Other comprehensive income:					
Unrealized gains on securities, net of reclassification adjust- ment (see below)	11,584	<u>11,584</u>		11,584	
Comprehensive income for the year		<u>\$ 1,104,830</u>			
Excise tax refunds (see note below)	17,192				17,192
Increase in memberships	<u>230</u>		<u>230</u>		
Balances, December 31, 2000	7,549,452		116,903	8,253	7,424,296
Comprehensive income:					
Net margins for the year	665,333	\$ 665,333			665,333
Other comprehensive income (loss):					
Unrealized losses on securities (926)	<u>(926)</u>		(926)	
Comprehensive income for the year		<u>\$ 664,407</u>			
Excise tax refunds (see note below)	18,384				18,384
Increase in memberships	<u>1,386</u>		<u>1,386</u>		
Balances, December 31, 2001	<u>\$ 8,233,629</u>		<u>\$ 118,289</u>	<u>\$ 7,327</u>	<u>\$ 8,108,013</u>

Disclosure of the reclassification amount:

Year ended December 31, 2000:

Unrealized holding gains arising during year	\$ 7,581
Reclassification adjustment for losses included in net margins	<u>4,003</u>
Net unrealized gains on securities	<u>\$ 11,584</u>

Note - The excise tax refunds were made by the Internal Revenue Service to the members. The Corporation is holding these refunds for the members as patronage capital.

The accompanying notes are an integral part of the consolidated financial statements

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF REVENUES AND EXPENSES

	Years Ended December 31	
	<u>2001</u>	<u>2000</u>
Operating revenues:		
Basic local network service	\$ 1,435,709	\$ 1,392,590
Network access and long-distance network service	3,250,606	3,141,948
Other	483,596	579,232
Cable television, programming, equipment sales, equipment lease, and other related revenue	4,190,548	3,872,973
Less, uncollectible revenues	(67,002)	(87,622)
	<u>9,293,457</u>	<u>8,899,121</u>
Operating expenses:		
Cost of cable television, programming, equipment sales, equipment lease, and other related revenue	1,795,478	1,651,566
Depreciation and amortization	1,648,299	1,294,887
Plant specific operations	1,072,941	1,057,859
Plant nonspecific operations	1,001,420	961,342
Customer operations	1,042,550	1,063,898
Corporate operations	1,849,458	1,609,316
Operating taxes:		
Income tax expense (benefits)	(31,220)	(32,256)
Other taxes	78,300	96,522
	<u>8,457,226</u>	<u>7,703,134</u>
Operating income	<u>836,231</u>	<u>1,195,987</u>
Nonoperating income (deductions):		
Interest and dividend income	271,544	227,293
Realized loss on sale of securities available for sale		(4,003)
Loss on disposal of assets		(9,090)
	<u>271,544</u>	<u>214,200</u>
Net margins before interest charges	<u>1,107,775</u>	<u>1,410,187</u>
Interest charges:		
Interest on long-term debt	491,166	519,701
Allowance for funds used during construction	(48,724)	(202,760)
	<u>442,442</u>	<u>316,941</u>
Net margins for the years	<u>\$ 665,333</u>	<u>\$ 1,093,246</u>

The accompanying notes are an integral part of the consolidated financial statements

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

	<u>Years Ended December 31</u>	
	<u>2001</u>	<u>2000</u>
Cash flows from operating activities:		
Net margins for the years	\$ 665,333	\$ 1,093,246
Adjustments to reconcile net margins to net cash provided by operating activities:		
Depreciation and amortization	1,648,299	1,294,887
Postretirement benefit accrual (net)	224,226	196,221
Allowance for doubtful accounts	18,563	58,370
Deferred income taxes	(55,700)	(57,563)
Cash value of life insurance	(146,665)	(7,659)
Stock dividend		43,983
Realized loss on securities available for sale		4,003
Changes in assets and liabilities:		
Accounts and notes receivable	27,021	(144,460)
Materials and supplies	(23,799)	(22,269)
Prepayments and deferred charges	(39,810)	(28,746)
Accounts payable	(216,748)	84,667
Customer deposits	12,020	(7,149)
Accrued and other current liabilities	113,660	(29,346)
Deferred compensation	(10,494)	(9,831)
Net cash provided by operating activities	<u>2,215,906</u>	<u>2,468,354</u>
Cash flows from investing activities:		
Extension and replacement of plant (net)	(1,235,969)	(1,559,278)
Purchase of securities available for sale	(10,687)	(56,000)
Proceeds from sale of securities available for sale	100,000	235,148
Other investments	58,538	(1,004,094)
Net cash used for investing activities	<u>(1,088,118)</u>	<u>(2,384,224)</u>
Cash flows from financing activities:		
Memberships issued (net)	1,386	230
Proceeds from long-term borrowings		430,000
Principal payments on long-term debt	(1,275,139)	(1,346,263)
Excise tax refunds	18,384	17,192
Net cash used for financing activities	<u>(1,255,369)</u>	<u>(898,841)</u>
Net decrease in cash and temporary investments	(127,581)	(814,711)
Cash and temporary investments - beginning of years	<u>1,399,224</u>	<u>2,213,935</u>
Cash and temporary investments - end of years	<u>\$ 1,271,643</u>	<u>\$ 1,399,224</u>
Cash expended during the years for:		
Interest (net of capitalized interest)	<u>\$ 391,092</u>	<u>\$ 375,224</u>
Income taxes	<u>\$ 20,243</u>	<u>\$ 30,000</u>
Noncash investing and financing activities:		
Purchase of capital term certificates with proceeds from Rural Telephone Finance Cooperative loan	\$ -0-	\$ 47,778
Equipment purchased under capital lease	<u>\$ 80,973</u>	<u>\$ 328,262</u>

The accompanying notes are an integral part of the consolidated financial statements

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS As of and for the Years Ended December 31, 2001 and 2000

1. Summary of Significant Accounting Policies:

These consolidated financial statements were prepared on the basis of accounting principles generally accepted in the United States of America, with the more significant of the principles used described as follows:

Basis of Consolidation

These consolidated financial statements include the accounts of Scott County Telephone Cooperative and its wholly-owned subsidiaries, Scott Telecom and Electronics, Inc., MountaiNet, Inc., and Scott County Long Distance, Inc. (hereinafter referred to collectively as the Corporation). The accounts of MountaiNet, Inc. include its wholly-owned subsidiaries, MountaiNet Long Distance, Inc. and MountaiNet Telephone Company, Inc. All material intercompany accounts and transactions have been eliminated in consolidation.

Cash and Temporary Investments

Cash and temporary investments include cash and short-term, highly liquid investments that are readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify as temporary investments.

Materials and Supplies

Inventories are valued at cost. The average cost method is used to value those items on which perpetual inventory records are kept, and the first-in, first-out method is used to value those items on which no perpetual inventory records are kept.

Intangible Assets

Debt issuance costs are amortized over the life of the associated loan.

Amortization of goodwill is computed by use of the straight-line method over fifteen years.

Other intangible assets are amortized by use of the straight-line method over their estimated useful lives.

Plant in Service and Under Construction

Additions to plant consist of all direct construction labor and materials, cost of plant construction, and related construction costs, including administrative, engineering, and general overhead.

The cost of units of property retired, including removal costs (net of salvage, if any), is deducted from accumulated depreciation, and the cost of related replacements considered to be units of property is added to plant.

Repairs to and replacement of items which are less than units of property are charged to maintenance expense.

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

1. Summary of Significant Accounting Policies (Continued):

Depreciation

Depreciation of plant in service is computed using the straight-line method.

Pension and Postretirement Benefit Plans

Pension and postretirement benefit costs are accrued and funded in accordance with Statements of Financial Accounting Standards (SFAS) No. 87 and No. 106.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Nature of Operations and Concentration of Credit Risk:

Scott County Telephone Cooperative is a cooperative telephone company that provides telephone services to its members. Scott County Telephone Cooperative has three wholly-owned subsidiaries: Scott Telecom and Electronics, Inc., which provides cable television services for its subscribers, as well as selling and leasing communications equipment; MountaiNet, Inc., a company that provides software and local access lines for its subscribers for use on the Internet; and Scott County Long Distance, Inc., which provides long-distance telecommunications services to its subscribers. MountaiNet, Inc. has two wholly-owned subsidiaries: MountaiNet Telephone Company, Inc., which provides local telecommunications services to its subscribers; and MountaiNet Long Distance, Inc., which provides long-distance telecommunications services to its subscribers. The consolidated Corporation's operating revenues consist of basic area revenue (16%), network access and long-distance services (36%), cable television and Internet services (42%), and other (6%).

The Corporation's policy is to maintain its cash balances in reputable financial institutions insured by the Federal Deposit Insurance Corporation, which provides \$100,000 of insurance coverage on each customer's cash balances. At times during the years, the Corporation's cash balances exceeded \$100,000. Management believes that this policy will not cause any adverse effect to the Corporation.

3. Construction Fund (Restricted):

The loan agreement with the Rural Utilities Service (RUS) restricts the use of cash in the RUS construction fund account to approved construction budget purposes in amounts approved for those purposes. The construction fund cash balance amounted to \$55,421 and \$91,935, respectively, at December 31, 2001 and 2000.

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

4. Property and Equipment:

The major classes of property and equipment are summarized as follows:

	<u>2001</u>	<u>2000</u>
Land	\$ 236,189	\$ 173,043
Vehicles and other work equipment	1,179,784	1,193,595
Buildings	1,404,428	1,354,920
Furniture and office equipment	825,495	786,124
Central office, headend, and other equipment	6,537,399	6,105,122
Outside plant	14,637,392	14,342,977
Leased phones and other	43,130	49,092
	<u>\$ 24,863,817</u>	<u>\$ 24,004,873</u>

A summary of plant depreciation is as follows:

	<u>2001</u>	<u>2000</u>
Amounts charged to depreciation expense	\$ 1,582,801	\$ 1,268,805

5. Other Investments:

A summary of other investments is as follows:

	<u>2001</u>	<u>2000</u>
Tennessee RSA No. 3 Limited Partnership	\$ 594,387	\$ 594,387
Scott County Cellular Telephone Company - Stock	13,265	13,265
Rural Telephone Finance Cooperative - Capital Term Certificates	103,144	130,796
National Bank of Cooperatives (CoBank) - Stock	116,850	184,830
Virginia Independent Telephone Alliance, LLC	154,034	116,940
Rural Telephone Bank - Stock	76,000	76,000
Cash surrender value of life insurance policies	1,152,228	1,005,563
Tennessee Independent Telecommunications Group, LLC	510,000	510,000
	<u>\$ 2,719,908</u>	<u>\$ 2,631,781</u>

The Corporation owns directly a 16.156% limited partnership interest and indirectly a .51% general partnership interest in Tennessee RSA No. 3 Limited Partnership. This partnership provides cellular telephone service in Tennessee Rural Service Area No. 3. The general partnership interest is owned through a corporation, Scott County Cellular Telephone Company, Inc., which owns a 1% interest in Tennessee RSA No. 3 Limited Partnership. The Corporation has a 51% ownership interest in Scott County Cellular Telephone Company, Inc..

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

6. Intangible Assets:

A summary is as follows:

	<u>2001</u>	<u>2000</u>
Goodwill	\$ 337,476	\$ 337,476
Customer list	<u>430,000</u>	<u>430,000</u>
	767,476	767,476
Less, accumulated amortization	<u>282,816</u>	<u>217,318</u>
	<u>\$ 484,660</u>	<u>\$ 550,158</u>
Amounts charged to amortization expense	<u>\$ 65,498</u>	<u>\$ 26,082</u>

7. Long-term Debt and Other Notes Payable:

Long-term debt consists of mortgage notes payable to the Rural Utilities Service, Rural Telephone Bank, and Rural Telephone Finance Cooperative, as well as a capital lease payable to Econocom-USA, Inc. An analysis of long-term debt follows:

	<u>2001</u>	<u>2000</u>
Rural Utilities Service (RUS):		
Payable \$3,302 per quarter, including interest at 2%	\$ 28,992	\$ 48,091
Payable \$42,867 per month, including interest at 5%	3,913,997	4,104,919
Payable \$72,546 per quarter, including interest at 5%	2,940,253	3,045,341
Rural Telephone Bank (RTB):		
Payable \$21,877 per month, including interest at 4%	479,407	546,069
Rural Telephone Finance Cooperative (RTFC):		
Quarterly payment with variable interest rate	584,521	1,408,337
Econocom-USA, Inc. (Capital Lease):		
Payable \$8,544 per month, including imputed interest at 9.25%	<u>315,434</u>	<u>304,013</u>
	8,262,604	9,456,770
Less, current maturities	<u>908,519</u>	<u>1,551,592</u>
	<u>\$ 7,354,085</u>	<u>\$ 7,905,178</u>

A substantial part of the Corporation's assets are pledged to secure the above debt.

The maturities of this debt for the next five years are as follows:

<u>Year Ending December 31</u>	<u>Amount</u>
2002	\$ 908,519
2003	757,858
2004	792,471
2005	797,402
2006	656,486

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

8. Capital Leases:

The Corporation is the lessee of Internet equipment under capital leases expiring in years 2005 and 2006. The assets and liabilities under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the asset. The assets are depreciated over the lower of their related lease terms or their estimated productive lives. Depreciation of assets under capital leases is included in depreciation expense for the year ended December 31, 2001.

The equipment and related accumulated depreciation under capital leases is included in property and equipment and accumulated depreciation on the Consolidated Balance Sheets at December 31, 2001. The following is a summary of equipment held under capital leases:

	<u>2001</u>	<u>2000</u>
Internet equipment	\$ 409,236	\$ 328,262
Less, accumulated depreciation	<u>101,033</u>	<u>21,884</u>
	<u>\$ 308,203</u>	<u>\$ 306,378</u>

Obligations under the capital leases are included with long-term debt on the Consolidated Balance Sheets at December 31, 2001, with the current portion of the obligation under capital leases included in current maturities on long-term debt. See Note 7 above. The Corporation's future minimum lease payments under capital lease obligations are as follows:

<u>Year Ending December 31</u>	<u>Amount</u>
2002	\$ 102,528
2003	102,528
2004	102,528
2005	64,903
2006	<u>397</u>
	372,884
Less, imputed interest	<u>57,450</u>
	<u>\$ 315,434</u>

9. Postretirement Benefits:

The Corporation has a postretirement benefit plan that covers all eligible employees, directors, and spouses. Benefits provided by this plan consist primarily of hospitalization insurance benefits which are provided by the payment of insurance premiums on behalf of eligible retirees.

The components of the Corporation's postretirement benefit costs are as follows:

	<u>2001</u>	<u>2000</u>
Service costs	\$ 99,180	\$ 72,015
Amortization costs - initial obligation	67,524	67,524
Amortization of gains	22,186	15,866
Interest costs on accumulated postretirement benefit obligation	<u>152,193</u>	<u>131,546</u>
	<u>\$ 341,083</u>	<u>\$ 286,951</u>

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

9. Postretirement Benefits (Continued):

A reconciliation of the postretirement benefit plan's funded status is as follows:

	<u>2001</u>	<u>2000</u>
Accumulated postretirement benefit obligation	\$ 1,861,358	\$ 1,704,656
Less, unamortized portion of initial obligation	<u>596,991</u>	<u>664,515</u>
Funded status which equals accrual included in noncurrent liabilities on the Corporation's Consolidated Balance Sheets	<u>\$ 1,264,367</u>	<u>\$ 1,040,141</u>

The assumed discount rate and rate of compensation increase is 6.5% and 6%, respectively. The assumed health care cost trend rate was projected to be 7% per year graded to 5.5% after five years. A 1% increase in the assumed trend rate would cause the service and interest costs to increase approximately \$83,765 per year and cause the accumulated postretirement benefit obligation to increase approximately \$440,360.

Postretirement benefits actually paid amounted to \$116,857 and \$90,730, respectively, in 2001 and 2000.

10. Pension and Deferred Compensation Plans:

The Corporation is a member of the National Telephone Cooperative Association's (NTCA's) multi-employer defined benefit pension plan. In general, all employees are eligible to participate after six months of service. The Corporation contributes 7.2% of the basic compensation of all eligible employees to the plan annually. The Corporation's pension costs for the years ended December 31, 2001 and 2000 amounted to \$147,687 and \$143,134, respectively.

In addition to the pension plan described above, the Corporation maintains a deferred compensation plan, as permitted by section 401(k) of the Internal Revenue Code, for all eligible employees. The Corporation contributes up to 2% of employees' basic annual salaries to this plan, which amounted to \$37,645 and \$38,308, respectively, for the years ended December 31, 2001 and 2000.

11. Investment in Equity Securities:

Cost and fair value of marketable equity securities as of December 31, 2001 and 2000 are as follows:

	<u>2001</u>			
	<u>Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Equity securities	<u>\$ 261,183</u>	<u>\$ 7,327</u>	<u>\$ -0-</u>	<u>\$ 268,510</u>

	<u>2000</u>			
	<u>Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Equity securities	<u>\$ 350,496</u>	<u>\$ 8,253</u>	<u>\$ -0-</u>	<u>\$ 358,749</u>

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

11. Investment in Equity Securities (Continued):

The average cost method is used to account for gains and losses on securities sold during the years.

The net unrealized holding gains have been credited to capitalization for the years ended December 31, 2001 and 2000.

12. Commitments and Contingencies:

The Corporation's shared revenues, which consist primarily of toll and access charges, are subject to periodic audits by the connecting carriers. The overpayments and underpayments arising from audits which took place during the years ended December 31, 2001 and 2000, if any, are reflected in the accompanying consolidated financial statements.

The Corporation has committed to make a capital call to the Tennessee Independent Telecommunications Group, LLC in the amount of \$500,000.

13. Income Tax Status:

Scott County Telephone Cooperative is chartered under Code section 501(c)(12)(A) of the Internal Revenue Code and is, therefore, exempt from federal and state income taxes if certain criteria are met, the most notable being the requirement that more than 85% of a cooperative's income must come from transactions with its members. Scott County Telephone Cooperative is subject to taxes based on their unrelated business income for federal purposes, and is subject to a minimum telecommunications tax for state purposes.

Scott Telecom and Electronics, Inc., Scott County Long Distance, Inc., and MountaiNet, Inc. and its subsidiaries, are taxable corporations for federal and state income tax purposes.

14. Income Taxes:

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Corporation's deferred tax assets and liabilities are as follows:

	<u>2001</u>	<u>2000</u>
Deferred tax assets:		
Book allowance for doubtful accounts	\$ 26,166	\$ 29,836
Book amortization of intangible assets	54,625	54,622
Net operating loss carryforwards	<u>751,645</u>	<u>671,421</u>
	832,436	755,879
Valuation allowance for deferred tax assets	(181,080)	(113,483)
	651,356	642,396
Deferred tax liabilities:		
Tax over book depreciation	<u>435,439</u>	<u>482,179</u>
Net deferred tax assets	<u>\$ 215,917</u>	<u>\$ 160,217</u>

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

14. Income Taxes (Continued):

Classification on the Corporation's Consolidated Balance Sheets is as follows:

	<u>2001</u>	<u>2000</u>
Current asset	\$ 26,164	\$ 29,836
Noncurrent asset	189,753	130,381
	<u>\$ 215,917</u>	<u>\$ 160,217</u>

Deferred taxes are computed separately for each taxable entity and combined for consolidated financial statement presentation.

The deferred income taxes are net of a valuation allowance of \$181,080 and \$113,483, respectively, for the years ended December 31, 2001 and 2000, to reflect the possibility that net operating loss carryforwards may expire before being utilized. The increase in the valuation allowance for the year ended December 31, 2001 amounted to \$67,597. There was no change in the valuation allowance for the year ended December 31, 2000.

Net operating losses may be carried forward for up to twenty years for federal and state income tax purposes as an offset against taxable income. Scott Telecom and Electronics, Inc., Scott County Long Distance, Inc., and MountaiNet, Inc. have net operating loss carryforwards as follows:

<u>Year Ended December 31</u>	<u>Scott Telecom and Electronics, Inc.</u>	<u>Scott County Long Distance, Inc.</u>	<u>MountaiNet, Inc.</u>
1992	\$ 149,727		
1993	470,557		
1994	365,990		
1997	137,062		
1998			\$ 71,186
1999			44,503
2000			19,161
2001		\$ 131,175	174,940
		9,155	512,196

MountaiNet, Inc. files a consolidated tax return with its subsidiaries as named in Note 1.

Components of the Corporation's income tax expense (benefit) are as follows:

	<u>2001</u>	<u>2000</u>
Current provision	\$ 24,480	\$ 25,307
Deferred provision	(55,700)	(57,563)
	<u>(\$ 31,220)</u>	<u>(\$ 32,256)</u>
Operating	(\$ 31,220)	(\$ 32,256)
Nonoperating	-0-	-0-
	<u>(\$ 31,220)</u>	<u>(\$ 32,256)</u>

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

15. Reclassifications:

Certain accounts in the prior year consolidated financial statements have been reclassified for comparative purposes to conform with the presentation in the current year consolidated financial statements.

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Certified Public Accountants

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INDEPENDENT AUDITORS' REPORT ON CONSOLIDATING INFORMATION

To the Board of Directors
Scott County Telephone Cooperative and Subsidiaries
Gate City, Virginia

Our report on our audits of the consolidated financial statements of Scott County Telephone Cooperative and Subsidiaries for the years ended December 31, 2001 and 2000 appears on page 1. Those audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information in Schedules I through III is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. Such information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidating financial statements taken as a whole.

Turlington and Company, L.L.P.

March 1, 2002

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

SCHEDULE I

CONSOLIDATING BALANCE SHEETS

ASSETS	2001 Consolidating Information					Consolidated	
	Scott County Telephone Cooperative	Scott Telecom and Electronics, Inc.	MountainNet, Inc.	Scott County Long Distance, Inc.	Consolidating Entries	December 31	
						2001	2000
Current assets:							
Cash and temporary investments	\$ 1,151,112	\$ 34,673	\$ 85,858			\$ 1,271,643	\$ 1,399,224
Customer accounts and notes receivable (less, allowances of \$139,968 and \$121,405, respectively)	346,362	6,529	192,544	\$ 46,397		591,832	622,196
Accounts receivable - intercompany	1,801,167			50,000	(\$ 1,851,167)		
Other accounts receivable (less, allowances of \$10,000 each year)	329,806						
Materials and supplies	255,022	143,967				329,806	345,027
Prepayments	26,591	12,922	11,282			398,989	375,190
Deferred charges			69,844			50,795	38,637
Deferred income taxes		3,276	20,106	2,782		69,844	42,192
	3,910,060	201,367	379,634	99,179	(1,851,167)	26,164	29,836
Noncurrent assets:						2,739,073	2,852,302
Investment in equity securities	268,510					268,510	358,749
Other investments	4,779,893	87,237	47,778		(2,195,000)	2,719,908	2,631,781
Notes receivable - intercompany	737,777				(737,777)		
Intangible assets (less, accumulated amortization of \$217,318 and \$191,236, respectively)		101,243	383,417				
Deferred income taxes		62,401	89,582	37,770		484,660	550,158
	5,786,180	250,881	520,777	37,770	(2,932,777)	189,753	130,381
Property and equipment:						3,662,831	3,671,069
Plant in service	18,204,533	5,287,293	1,371,991			24,863,817	24,004,873
Plant under construction	1,322,186	14,191				1,336,377	1,075,215
	19,526,719	5,301,484	1,371,991			26,200,194	25,080,088
Less, accumulated depreciation	9,300,023	3,750,088	517,467			13,567,578	12,181,613
	10,226,696	1,551,396	854,524			12,632,616	12,898,475
	\$ 19,922,936	\$ 2,003,644	\$ 1,754,935	\$ 136,949	(\$ 4,783,944)	\$ 19,034,520	\$ 19,421,846
LIABILITIES AND CAPITALIZATION							
Current liabilities:							
Accounts payable	\$ 428,292	\$ 57,424	\$ 98,833			\$ 584,549	\$ 801,297
Accounts payable - intercompany	50,000	533,066	1,037,287	\$ 230,814	(\$ 1,851,167)		
Customer deposits	41,843		2,033			43,876	31,856
Current maturities on long-term debt	831,989	159,639	223,809		(306,918)	908,519	1,551,592
Accrued and other current liabilities	491,272	52,928				544,200	430,541
	1,843,396	803,057	1,361,962	230,814	(2,158,085)	2,081,144	2,815,286
Noncurrent liabilities:							
Long-term debt, less current maturities	7,115,181		238,904			7,354,085	7,905,178
Notes payable - intercompany		75,388	355,471		(430,859)		
Deferred compensation	101,295					101,295	111,789
Postretirement benefits	1,264,367					1,264,367	1,040,141
	8,480,843	75,388	594,375		(430,859)	8,719,747	9,057,108
	10,324,239	878,445	1,956,337	230,814	(2,588,944)	10,800,891	11,872,394
Capitalization:							
Memberships	118,289					118,289	116,903
Common stock		32,000	3,500	2,000	(37,500)		
Additional paid-in capital		1,768,000	341,500	48,000	(2,157,500)		
Accumulated other comprehensive income	7,327					7,327	8,253
Patronage capital	9,473,081	(674,801)	(546,402)	(143,865)		8,108,013	7,424,296
	9,598,697	1,125,199	(201,402)	(93,865)	(2,195,000)	8,233,629	7,549,452
	\$ 19,922,936	\$ 2,003,644	\$ 1,754,935	\$ 136,949	(\$ 4,783,944)	\$ 19,034,520	\$ 19,421,846

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

SCHEDULE II

CONSOLIDATING STATEMENTS OF REVENUES AND EXPENSES

2001 Consolidating Information

Consolidated

	Scott County Telephone Cooperative	Scott Telecom and Electronics, Inc.	MountaiNet, Inc.	Scott County Long Distance, Inc.	Consolidating Entries	Years Ended December 31 2001	2000
Operating revenues:							
Basic local network service	\$ 1,480,024		\$ 35,456		(\$ 79,771)	\$ 1,435,709	\$ 1,392,590
Network access and long-distance network service	2,856,979		48,992	\$ 656,584	(311,949)	3,250,606	3,141,948
Other	602,629				(119,033)	483,596	579,232
Cable television, programming, equipment sales, equipment lease, and other related revenue	6,839	\$ 1,690,363	2,493,346			4,190,548	3,872,973
Less, uncollectible revenues	(18,131)		(48,871)			(67,002)	(87,622)
	<u>4,928,340</u>	<u>1,690,363</u>	<u>2,528,923</u>	<u>656,584</u>	<u>(510,753)</u>	<u>9,293,457</u>	<u>8,899,121</u>
Operating expenses:							
Cost of cable television, programming, equipment sales, equipment lease, and other related revenue	1,812	671,156	1,250,704		(128,194)	1,795,478	1,651,566
Depreciation and amortization	1,008,306	390,006	249,987			1,648,299	1,294,887
Plant specific operations	990,325	80,615	2,001			1,072,941	1,057,859
Plant nonspecific operations	258,658	13,631	491,026	495,937	(257,832)	1,001,420	961,342
Customer operations	485,230	219,391	262,218	192,596	(116,885)	1,042,550	1,063,898
Corporate operations	1,011,260	219,730	615,353	10,957	(7,842)	1,849,458	1,609,316
Operating taxes:							
Income tax expense (benefits)	24,480	18,204	(71,440)	(2,464)		(31,220)	(32,256)
Other taxes	74,476	3,522	302			78,300	96,522
	<u>3,854,547</u>	<u>1,616,255</u>	<u>2,800,151</u>	<u>697,026</u>	<u>(510,753)</u>	<u>8,457,226</u>	<u>7,703,134</u>
Operating income (loss)	<u>1,073,793</u>	<u>74,108</u>	<u>(271,228)</u>	<u>(40,442)</u>		<u>836,231</u>	<u>1,195,987</u>
Nonoperating income (deductions):							
Interest and dividend income	360,153	1,207			(89,816)	271,544	227,293
Realized loss on sale of securities available for sale							(4,003)
Loss on disposal of assets							(9,090)
	<u>360,153</u>	<u>1,207</u>			<u>(89,816)</u>	<u>271,544</u>	<u>214,200</u>
Net margins (losses) before interest charges	<u>1,433,946</u>	<u>75,315</u>	<u>(271,228)</u>	<u>(40,442)</u>	<u>(89,816)</u>	<u>1,107,775</u>	<u>1,410,187</u>
Interest charges:							
Interest on long-term debt	458,677	38,580	83,725		(89,816)	491,166	519,701
Allowance for funds used during construction	(48,724)					(48,724)	(202,760)
	<u>409,953</u>	<u>38,580</u>	<u>83,725</u>		<u>(89,816)</u>	<u>442,442</u>	<u>316,941</u>
Net margins (losses) for the years	<u>\$ 1,023,993</u>	<u>\$ 36,735</u>	<u>(\$ 354,953)</u>	<u>(\$ 40,442)</u>	<u>\$ -0-</u>	<u>\$ 665,333</u>	<u>\$ 1,093,246</u>

SCOTT COUNTY TELEPHONE COOPERATIVE AND SUBSIDIARIES

SCHEDULE III

CONSOLIDATING STATEMENTS OF CASH FLOWS

	2001 Consolidating Information					Consolidated	
	Scott County Telephone Cooperative	Scott Telecom and Electronics, Inc.	MountainNet, Inc.	Scott County Long Distance, Inc.	Consolidating Entries	Years Ended December 31 2001	2000
Cash flows from operating activities:							
Net margins (losses) for the years	\$ 1,023,993	\$ 36,735	(\$ 354,953)	(\$ 40,442)		\$ 665,333	\$ 1,093,246
Adjustments to reconcile net margins (losses) to net cash provided by operating activities:							
Depreciation and amortization	1,008,306	390,006	249,987			1,648,299	1,294,887
Postretirement benefit accrual (net)	224,226					224,226	196,221
Allowance for doubtful accounts	29,925	(6,300)	(5,062)			18,563	58,370
Deferred income taxes		18,203	(71,439)	(2,464)		(55,700)	(57,563)
Cash value of life insurance	(146,665)					(146,665)	(7,659)
Stock dividend							43,983
Realized loss on securities available for sale							4,003
Changes in assets and liabilities:							
Accounts and notes receivable	(23,413)	44,032	63,134	(56,732)		27,021	(144,460)
Accounts receivable - intercompany	(505,395)				\$ 505,395		
Materials and supplies	(19,137)	(4,662)				(23,799)	(22,269)
Prepayments and deferred charges	(1,959)	333	(38,184)			(39,810)	(28,746)
Accounts payable	(220,199)	1,419	2,032			(216,748)	84,667
Accounts payable - intercompany	(79,241)	484,998	99,638	(505,395)			
Customer deposits	9,987		2,033			12,020	(7,149)
Accrued and other current liabilities	95,383	18,277				113,660	(29,346)
Deferred compensation	(10,494)					(10,494)	(9,831)
Net cash provided by operating activities	1,464,558	418,802	332,546	-0-	-0-	2,215,906	2,468,354
Cash flows from investing activities:							
Extension and replacement of plant (net)	(1,005,152)	(118,762)	(112,055)			(1,235,969)	(1,559,278)
Purchase of securities available for sale	(10,687)					(10,687)	(56,000)
Proceeds from sale of securities available for sale	100,000					100,000	235,148
Collections on loans to affiliates	646,675				(646,675)		
Other investments	799	57,739				58,538	(1,004,094)
Net cash used for investing activities	(268,365)	(61,023)	(112,055)		(646,675)	(1,088,118)	(2,384,224)
Cash flows from financing activities:							
Memberships issued (net)	1,386					1,386	230
Proceeds from long-term borrowings							430,000
Principal payments on long-term debt	(1,205,587)	(511,507)	(204,720)		646,675	(1,275,139)	(1,346,263)
Excise tax refunds	18,384					18,384	17,192
Net cash used for financing activities	(1,185,817)	(511,507)	(204,720)		646,675	(1,255,369)	(898,841)
Net increase (decrease) in cash and temporary investments	10,376	(153,728)	15,771	-0-		(127,581)	(814,711)
Cash and temporary investments - beginning of years	1,140,736	188,401	70,087	-0-		1,399,224	2,213,935
Cash and temporary investments - end of years	\$ 1,151,112	\$ 34,673	\$ 85,858	\$ -0-	\$ -0-	\$ 1,271,643	\$ 1,399,224
Cash expended during the years for:							
Interest (net of capitalized interest)	\$ 358,603	\$ 38,580	\$ 83,725	\$ -0-	(\$ 89,816)	\$ 391,092	\$ 375,224
Income taxes	\$ 20,243	\$ -0-	\$ -0-	\$ -0-	\$ -0-	\$ 20,243	\$ 30,000
Noncash investing and financing activities:							
Purchase of capital term certificates with proceeds from Rural Telephone Finance Cooperative loan						\$ -0-	\$ 47,778
Equipment purchased under capital lease			\$ 80,973			\$ 80,973	\$ 328,262

Turlington and Company, L.L.P.

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INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Board of Directors
Scott County Telephone Cooperative and Subsidiaries
Gate City, Virginia

We have audited the consolidated financial statements of Scott County Telephone Cooperative and Subsidiaries as of and for the years ended December 31, 2001 and 2000, and have issued our report thereon dated March 1, 2002. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

COMPLIANCE

As part of obtaining reasonable assurance about whether Scott County Telephone Cooperative and Subsidiaries' consolidated financial statements are free of material misstatement, we performed tests of their compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of consolidated financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audits, we considered Scott County Telephone Cooperative and Subsidiaries' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND ON
INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF
CONSOLIDATED FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS (CONTINUED)**

This report is intended solely for the information and use of the Board of Directors, management, others within the organization, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Durlington and Company, L.L.P.

March 1, 2002

Turlington and Company, L.L.P.

Certified Public Accountants

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Board of Directors
Scott County Telephone Cooperative and Subsidiaries
Gate City, Virginia

We have audited the consolidated financial statements of Scott County Telephone Cooperative and Subsidiaries for the year ended December 31, 2001, and have issued our report thereon dated March 1, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and 7 CFR part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

In planning and performing our audit of the consolidated financial statements of Scott County Telephone Cooperative and Subsidiaries for the year ended December 31, 2001, we considered their internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurance on the internal control over financial reporting.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the consolidated financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting that we consider to be material weaknesses.

Section 1773.33 requires comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the consolidated financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control over financial reporting, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.33 (e)(2), and related party transactions and investments. In addition, our audit of the consolidated financial statements also included the procedures specified in 7 CFR 1773.38-45. Our objective was not to provide an opinion on these specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports other than our Independent Auditors' Report and our Independent Auditors' Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Consolidated Financial Statements Performed in Accordance with *Government Auditing Standards*, all dated March 1, 2002, or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control over financial reporting, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR 1773.33 are presented below.

COMMENTS ON CERTAIN SPECIFIC ASPECTS OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

We noted no matters regarding Scott County Telephone Cooperative and Subsidiaries' internal control over financial reporting and their operations that we consider to be material weaknesses as previously defined with respect to:

- The accounting procedures and records;
- The process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts; and
- The materials control.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS

At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, contracts, and grants. The procedures we performed are summarized as follows:

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract, agreement, or lease between the borrower and an affiliate of Scott County Telephone Cooperative and Subsidiaries for the year ended December 31, 2001:
 1. Obtained and read a borrower-prepared schedule of new written contracts, agreements, or leases entered into during the year between the borrower and an affiliate as defined in §1773.33 (e)(2)(i).
 2. Reviewed Board of Director minutes to ascertain whether Board-approved written contracts are included in the borrower-prepared schedule.
 3. Noted the existence of written RUS approval of each contract listed by the borrower.

COMMENTS ON COMPLIANCE WITH SPECIFIC RUS LOAN AND SECURITY INSTRUMENT PROVISIONS (CONTINUED)

- Procedures performed with respect to the requirement to submit RUS Form 479 to the RUS:
 1. No procedures were performed regarding Form 479 as the updated document has not been released by the RUS. The subsidiaries are not required to submit Form 479.

The results of our tests indicate that, with respect to the items tested, Scott County Telephone Cooperative and Subsidiaries complied, except as noted below, in all material respects, with the specific RUS loan and security instrument provisions referred to below. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower has obtained written approval of the RUS to enter into any contract, agreement, or lease with an affiliate as defined in §1773.33 (e)(2)(i), and
- The borrower has submitted its Form 479 to the RUS and the Form 479, *Financial and Statistical Report*, as of December 31, 2001, represented by the borrower as having been submitted to the RUS, is in agreement with Scott County Telephone Cooperative's audited records in all material respects; however, RUS Form 479 has not been submitted due to delays in the release of the updated document by the RUS. The subsidiary is not required to submit Form 479.

COMMENTS ON OTHER ADDITIONAL MATTERS

In connection with our audit of the consolidated financial statements of Scott County Telephone Cooperative and Subsidiaries, nothing came to our attention that caused us to believe that Scott County Telephone Cooperative and Subsidiaries failed to comply with respect to:

- The reconciliation of subsidiary plant records to the controlling general ledger plant accounts addressed at 7 CFR 1773.33 (c)(1);
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.33 (c)(2);
- The retirement of plant addressed at 7 CFR 1773.33 (c)(3) and (4);
- The approval of the sale, lease or transfer of capital assets and disposition of proceeds for the sale or lease of plant, material, or scrap addressed at 7 CFR 1773.33 (c)(5);
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards No. 57, *Related Party Transactions*, for the year ended December 31, 2001, in the consolidated financial statements referenced in the first paragraph of this report addressed at 7 CFR 1773.33 (e); and
- The detailed schedule of investments.

COMMENTS ON OTHER ADDITIONAL MATTERS (CONTINUED)

Our audit was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The detailed schedule of investments required by 7 CFR 1773.33 (h), and provided below, is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. This information has been subjected to the auditing procedures applied in our audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Summary of Investments

	Scott Telecom & Electronics, Inc.	MountaiNet, Inc.	Scott County Long Distance, Inc.	Scott County Cellular Telephone Company, Inc.	Tennessee RSA No. 3 Limited Partnership	Virginia Independent Telephone Alliance, LLC	Tennessee Independent Telecommuni- cations Group, LLC
Carrying value of investment as of December 31, 1999	\$ 1,800,000	\$ 350,000		\$ 13,265	\$ 594,387	\$ 116,940	\$ 110,000
Investment advances for year ended December 31, 2000			\$ 50,000				400,000
Dividends for year ended December 31, 2000		5,000			161,560		
Undistributed earnings (loss) for year ended December 31, 2000	15,892	(65,463)	(103,423)	7,570	239,807		(29,018)*
Carrying value of investment as of December 31, 2000	1,800,000	345,000	50,000	13,265	594,387	116,940	510,000
Investment advances for year ended December 31, 2001						37,094	
Dividends for year ended December 31, 2001					161,560		
Undistributed earnings (loss) for year ended December 31, 2001	36,735	(354,953)	(40,442)	10,708	339,221	Unavailable	(118,208)
Carrying value of investment as of December 31, 2001	1,800,000	345,000	50,000	13,265	594,387	154,034	510,000

* Includes the period of November 25, 1998 to December 31, 2000

Scott Telecom and Electronics, Inc. is a wholly-owned subsidiary of Scott County Telephone Cooperative that provides cable television services. This investment is accounted for on the cost basis on Scott County Telephone Cooperative's (parent company) books, and is consolidated for financial statement purposes. In addition to the investment listed above, at December 31, 2001, Scott Telecom and Electronics, Inc. had an accounts payable balance to the parent company of \$533,066 and also owes the parent company \$235,027 on notes payable.

MountainNet, Inc. is a wholly-owned subsidiary of Scott County Telephone Cooperative that provides Internet and telecommunications services. This investment is accounted for on the cost basis on Scott County Telephone Cooperative's (parent company) books, and is consolidated for financial statement purposes. In addition to the investment listed above, at December 31, 2001, MountainNet, Inc. had an accounts payable balance to the parent company of \$1,037,287 and also owes the parent company \$502,750 on notes payable.

Scott County Long Distance, Inc. is a wholly-owned subsidiary of Scott County Telephone Cooperative that provides telecommunications services. This investment is accounted for on the cost basis on Scott County Telephone Cooperative's (parent company) books, and is consolidated for financial statement purposes. In addition to the investment listed above, at December 31, 2001, Scott County Long Distance, Inc. had a net accounts payable balance to the parent company of \$180,814.

Scott County Cellular Telephone Company, Inc. is the general partner that owns 1% of Tennessee RSA No. 3 Limited Partnership. Scott County Telephone Cooperative owns 51% of the outstanding stock of Scott County Cellular Telephone Company, Inc. and accounts for the investment on the cost basis.

Tennessee RSA No. 3 Limited Partnership is a limited partnership providing cellular telephone services. Scott County Telephone Cooperative owns a 16.156% interest in Tennessee RSA No. 3 Limited Partnership and accounts for the investment on the cost basis.

Tennessee Independent Telecommunications Group, LLC is a limited liability company providing a fiber optic network throughout Tennessee. Scott County Telephone Cooperative owns a 10% interest in Tennessee Independent Telecommunications Group, LLC and accounts for the investment on the cost basis.

Virginia Independent Telephone Alliance, LLC is a limited liability company providing SS7 connectivity throughout Virginia. Scott County Telephone Cooperative owns a 6.4% interest in Virginia Independent Telephone Alliance, LLC and accounts for the investment on the cost basis.

This report is intended solely for the information and use of the Board of Directors, management, the Rural Utilities Service, and supplemental lenders, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Durlington and Company, L.L.P.

March 1, 2002

MountaiNet Telephone Company
May 3, 2002

Attachment 2

Annual Capital Expenses
Detail of Switch Capital Expenditures
Capital Investment Forecasted Financial Schedule
Three-year Depreciation Schedule

This exhibit is confidential and has been filed under seal.

MountaiNet Telephone Company
May 3, 2002

Attachment 3

Corporate Surety Bond

TENNESSEE REGULATORY AUTHORITY

TENNESSEE TELECOMMUNICATIONS SERVICE PROVIDER'S SURETY BOND

Bond #: 103659547

WHEREAS, MountiaNet Telephone Company (the "Principal"),
has applied to the Tennessee Regulatory Authority for authority to provide telecommunications services in the State of Tennessee; and

WHEREAS, under the provisions of Title 65, Chapter 4, Section 125(j) of the Tennessee Code Annotated, as amended, the Principal is required to file this bond in order to obtain such authority and to secure the payment of any monetary sanction imposed in any enforcement proceeding brought under Title 65 of the Tennessee Code Annotated or the Consumer Telemarketing Act of 1990 by or on behalf of the Tennessee Regulatory Authority (the "TRA"); and

WHEREAS, Travelers Casualty and Surety Co. of America
(the "Surety"), a corporation licensed to do business in the State of Tennessee and duly authorized by the Tennessee Commissioner of Insurance to engage in the surety business in this state pursuant to Title 56, Chapter 2 of the Tennessee Code Annotated, has agreed to issue this bond in order to permit the Principal to comply with the provisions of Title 65, Chapter 4, Section 125(j) of the Tennessee Code Annotated;

NOW THEREFORE, BE IT KNOWN, that we the Principal and the Surety are held and firmly bound to the STATE OF TENNESSEE, in accordance with the provisions of Tennessee Code Annotated, Title 65, Chapter 4, Section 125(j), in the full amount of twenty thousand dollars (\$20,000.00) lawful money of the United States of America to be used for the full and prompt payment of any monetary sanction imposed against the Principal, its representatives, successors or assigns, in any enforcement proceeding brought under Title 65 of Tennessee Code Annotated or the Consumer Telemarketing Act of 1990, by or on behalf of the TRA, for which obligation we bind ourselves, our representatives, successors and assigns, each jointly and severally, firmly and unequivocally by these presents.


This bond shall become effective on the 16th day of April, 2002, and shall be continuous; provided, however, that each annual renewal period or portion thereof shall constitute a new bond term. Regardless of the number of years this bond may remain in force, the liability of the Surety shall not be cumulative, and the aggregate liability of the Surety for any and all claims, suits or actions under this bond shall not exceed Twenty Thousand Dollars (\$20,000.00). The Surety may cancel this bond by giving thirty (30) days written notice of such cancellation to the TRA and Principal by certified mail, it being understood that the Surety shall not be relieved of liability that may have accrued under this bond prior to the date of cancellation.

PRINCIPAL

MountiaNet Telephone Company
Name of Company authorized by the TRA

Company ID # as assigned by TRA

SIGNATURE OF PRINCIPAL


Name: David R. Clark
Title: EXECUTIVE VP

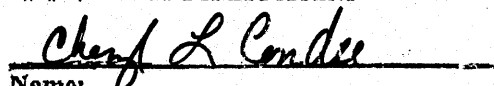
SURETY

Travelers Casualty and
Surety Co. of America

Name of Surety
2550 Eisenhower Avenue
Trooper, PA 19403

Address of Surety

SIGNATURE OF SURETY AGENT


Name: Cheryl L. Condee
Title: Attorney-in-fact

Address of Surety Agent:
6301 Ivy Lane, Suite 506
Greenbelt, MD 20770

THIS BOND IS ISSUED IN ACCORDANCE WITH THE PROVISIONS OF SECTION 125, CHAPTER 4, TITLE 65 OF THE TENNESSEE CODE ANNOTATED AS AMENDED BY CHAPTER NO. 586, 2000 PUBLIC ACTS. SHOULD THERE BE ANY CONFLICT WITH THE TERMS HEREOF AND THE STATUTE OR REGULATIONS PROMULGATED THEREUNDER, THE STATUTE OR REGULATIONS SHALL PREVAIL. (POWER OF ATTORNEY FROM AN APPROVED INSURANCE COMPANY MUST BE ATTACHED.)

ACKNOWLEDGMENT OF PRINCIPAL

Virginia
STATE OF ~~TENNESSEE~~
COUNTY OF Scott

Before me, a Notary Public of the State and County aforesaid, personally appeared Blane Clark
with whom I am personally acquainted and who, upon oath, acknowledged himself to be the individual who
executed the foregoing bond on behalf of Mountainet Telephone Co, and he acknowledged to me that he
executed the same.

WITNESS my hand and seal this 16th day of April, 2002.

My Commission Expires:

June 30, 2003

Rebecca M. David
Notary Public

ACKNOWLEDGMENT OF SURETY

STATE OF ~~TENNESSEE~~ MARYLAND
COUNTY OF Prince Georges

Before me, a Notary Public of the State and County aforesaid, personally appeared Chen L. Conder
with whom I am personally acquainted and who, upon oath, acknowledged himself to be the individual
who executed the foregoing bond on behalf of Travelers, the within named Surety, a corporation
Casualty and Surety Co. of America

licensed to do business in the State of Tennessee and duly authorized by the Tennessee Commissioner of Insurance to
engage in the surety business in this state pursuant to Title 56, Chapter 2 of the Tennessee Code Annotated, and that he as
such an individual being authorized to do so, executed the foregoing bond, by signing the name of the corporation by
himself and as such individual.

WITNESS my hand and seal this 17th day of April, 2002

My Commission Expires:

May 1, 2002

Chen L. Pearson
Notary Public

APPROVAL AND INDORSEMENT

This is to certify that I have examined the foregoing bond and found the same to be sufficient and in conformity to law,
that the sureties on the same are good and worth the penalty thereof, and that the same has been filed with the Tennessee
Regulatory Authority, State of Tennessee, this _____ day of _____, 20____.

Name: _____

Title: _____

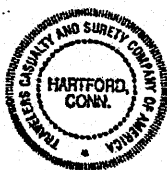
IN WITNESS WHEREOF, TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA, TRAVELERS CASUALTY AND SURETY COMPANY and FARMINGTON CASUALTY COMPANY have caused this instrument to be signed by their Senior Vice President and their corporate seals to be hereto affixed this 16th day of August 2001.


STATE OF CONNECTICUT

}SS. Hartford

TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA
TRAVELERS CASUALTY AND SURETY COMPANY
FARMINGTON CASUALTY COMPANY

COUNTY OF HARTFORD



By 
George W. Thompson
Senior Vice President

On this 16th day of August, 2001 before me personally came **GEORGE W. THOMPSON** to me known, who, being by me duly sworn, did depose and say: that he/she is Senior Vice President of **TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA, TRAVELERS CASUALTY AND SURETY COMPANY** and **FARMINGTON CASUALTY COMPANY**, the corporations described in and which executed the above instrument; that he/she knows the seals of said corporations; that the seals affixed to the said instrument are such corporate seals; and that he/she executed the said instrument on behalf of the corporations by authority of his/her office under the Standing Resolutions thereof.



Marie C Tetreault

My commission expires June 30, 2006 Notary Public
Marie C. Tetreault

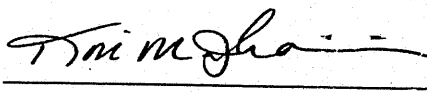
CERTIFICATE

I, the undersigned, Assistant Secretary of **TRAVELERS CASUALTY AND SURETY COMPANY OF AMERICA, TRAVELERS CASUALTY AND SURETY COMPANY** and **FARMINGTON CASUALTY COMPANY**, stock corporations of the State of Connecticut, DO HEREBY CERTIFY that the foregoing and attached Power of Attorney and Certificate of Authority remains in full force and has not been revoked; and furthermore, that the Standing Resolutions of the Boards of Directors, as set forth in the Certificate of Authority, are now in force.

Signed and Sealed at the Home Office of the Company, in the City of Hartford, State of Connecticut. Dated this _____ day of _____, 20__

day of



By 
Kori M. Johanson
Assistant Secretary, Bond

MountaiNet Telephone Company
May 3, 2002

Attachment 4

U.S. Department of Agriculture Rural Utilities Service
Management Services Agreement

U. S. DEPARTMENT OF AGRICULTURE
RURAL UTILITIES SERVICE

RUS BORROWER DESIGNATION Virginia 510 Scott County

THE WITHIN Management Service Agreement Between Scott County Telephone
Co-operative and MountaiNet, Inc.

SUBMITTED BY THE ABOVE DESIGNATED BORROWER PURSUANT TO THE
TERMS OF THE LOAN CONTRACT, IS HEREBY APPROVED SOLELY FOR THE
PURPOSES OF SUCH CONTRACT.

Allen D. Nance
FOR THE ADMINISTRATOR

DATED

3-13-96

SERVICE AGREEMENT

This Service Agreement executed this 1st day of December, 1995, by and between Scott County Telephone Cooperative, a corporation chartered in Virginia, and MountaiNet, Inc., a corporation chartered in Virginia.

WITNESSETH:

WHEREAS, MountaiNet, Inc. is a wholly owned subsidiary of the Scott County Telephone Cooperative (SCTC); and

WHEREAS, MountaiNet has a need for the service, assistance and advice of the SCTC officers and employees experienced in the management and operation of a telecommunications and cable company and SCTC is able and willing to provide such expertise and services;

NOW, THEREFORE, the parties hereto, intending to be legally bound, agree as follows:

1. Scope of Service. SCTC shall provide such management, supervisory, construction, engineering, material handling, accounting, budgeting, customer billing, accounts payable, financial reporting, marketing, computer and administrative services as MountaiNet may require during the term of this agreement.

2. Reimbursement for Services. MountaiNet shall reimburse SCTC for the services provided by each SCTC employee pursuant to this Agreement a monthly amount equal to SCTC's fully loaded labor expenses, including salaries, benefits, applicable taxes, insurance, pension, medical and other benefits and other overhead expenses, but not including any amount for profit.

In addition to the above, MountaiNet shall reimburse SCTC for all reasonable and necessary expenses incurred by SCTC employees in the provision of services to MountaiNet hereunder, as reported by such employees and paid by SCTC in accordance with SCTC's standard policies and procedures for such expenses. MountaiNet shall also reimburse SCTC for all reasonable and necessary expenses incurred by SCTC in the performance of this Agreement. Any expense incurred which cannot be identified to SCTC or MountaiNet may be allocated between SCTC and MountaiNet by using mutually agreeable allocation methods generally accepted for ratemaking and financial reporting purposes.

3. **Billing and Payment.** SCTC shall invoice MountaiNet on or before the last working day of each month for reimbursement of amounts paid during the preceding month, in accordance with paragraph 2 hereof. MountaiNet shall pay such invoice net fifteen (15) days from the invoice date. Payment of any invoice shall not waive the right of MountaiNet to protest or question the correctness of such invoice or to seek a refund from SCTC of any incorrect item.

4. **Records, Audits, and Cooperation in Legal Proceedings.** SCTC shall maintain records sufficiently reasonable to show the cost of rendering the services provided to MountaiNet hereunder. MountaiNet shall have the right to examine such records and related accounts of SCTC at any time upon reasonable notice. SCTC shall cooperate fully with MountaiNet (a) in securing any required regulatory approvals of this agreement, and (b) in complying with requests for relevant records, accounts and information concerning the service rendered hereunder, the costs thereof and allocation of such costs between SCTC and MountaiNet in connection with any regulatory proceeding wherein the rates and practices of MountaiNet are at issue or any other legal proceeding.

5. **Term.** The term of this agreement shall be one (1) year from the date first written above, subject to any necessary regulatory approval hereof, and from month to month thereafter, provided, however, that any party may terminate this Agreement at any time upon thirty (30) days written notice.

6. **Indemnification.** Unless otherwise provided by law, and to the maximum extent that MountaiNet may be authorized by law, MountaiNet shall indemnify SCTC and any SCTC employee who was or is assigned to provide services to MountaiNet hereunder and who was or is a party to or a witness in, or who is threatened to be made a party or a witness in, any threatened, pending or completed action, suite or proceeding, whether civil, criminal, administrative or investigative, by reason of or in any way connected with this Agreement or the performance thereof, against all expenses (including attorney's fees and disbursements), liabilities, claims, judgments, fines, and amounts paid in settlements actually and reasonably incurred by SCTC or such person in connection with such action, suit or proceeding; and shall pay expenses (including attorney's fees and disbursements) incurred by SCTC and any SCTC employee who was or is assigned to provide services to MountaiNet hereunder in defending or appearing as a witness in any action, suit, or proceeding described in this paragraph. The expenses shall be paid by MountaiNet upon final disposition of such action, suit or proceeding upon receipt of any undertaking by or on behalf of the indemnified party to repay all amounts advanced if it shall ultimately be determined that such party is not entitled to be indemnified by MountaiNet. The rights of indemnification and advancement of expenses provided by this paragraph shall continue as to a SCTC

employee who has ceased to be assigned to provide services to MountaiNet hereunder and shall inure to the benefit of heirs, executors and administrators of such person. Indemnification and advancement of expenses under this paragraph shall be provided whether or not the indemnified liability arises or arose from any threatened, pending or completed action by or in the right of MountaiNet.

7. Responsibility for Expenses. Except as otherwise specifically provided herein, each party hereto shall bear its own expenses (including the expenses and fees of counsel and others retained by such party) incurred in connection with obtaining regulatory approval of this Agreement.

8. Governing Law. This Agreement shall be governed, construed, and enforced in accordance with the laws of the State of Virginia.

9. Assignment. This Agreement shall inure to the benefit of the successors and assigns of the parties.

10. Required Provisions. Any provisions required to be included in a contract of this type by any applicable and valid federal, state, or local law, ordinance, rule or regulation shall be deemed to be incorporated herein.

SCTC shall be under no obligation to provide to MountaiNet any facilities, employees, or other resources or services that may be detrimental to the operation of SCTC.

This Agreement shall become effective only upon approval thereof in writing by the Administrator of the Rural Utilities Service ("Administrator").

The parties hereto agree to terminate this Agreement when requested to do so by the Administrator.

No amendment shall be made to this Agreement without consent of the Administrator.

Neither party shall have the right to assign this Agreement, except to the United States of America, without the consent in writing of the other parties and of the Administrator.

11. Entire Agreement. This Agreement contains the entire agreement between the parties relating to the subject matter hereof. No terms or conditions other than those stated herein, and no agreement or understanding, oral or written, in any way purporting to modify the terms and conditions of this Agreement, shall be binding on any party unless hereafter made in writing signed by an authorized representative of each party.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their duly authorized representatives as of the date first above written.

SCOTT COUNTY TELEPHONE
COOPERATIVE

MOUNTAINET, INC.

By:

John Brickey, Jr.
John Brickey, Jr.

By:

Paul Kilgore
Paul Kilgore

Title: President

Title: President

Date: 1/15/96

Date: 12-24-95

USDA

RECEIVED MAR 18 1996

**United States
Department of
Agriculture**

Rural Utilities Service

Washington, DC 20250-1500

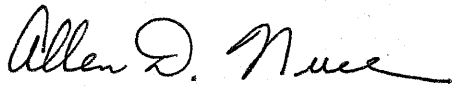
MAR 14 1996

Mr. Daniel E. Odom
Administrative Manager
Scott County Telephone
Co-operative
P. O. Box 487
Gate City, Virginia 24251

Dear Mr. Odom:

Thank you for submitting the proposed service agreement between Scott County Telephone Co-operative and MountaiNet, Inc. RUS has reviewed and approved this agreement. We are enclosing two copies of the agreement for your records.

Sincerely,



ALLEN D. NUCE, Chief
Southeast Operations Branch
Eastern Regional Division

Enclosures